The Financial Reporting Consequences of Proximity to Political Power

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Accepted for publication in the *Journal of Accounting and Public Policy*

Key terms: earnings management, proximity to political power, political alignment, empirical financial accounting

JEL classifications: M41, M48

Data availability: Financial data are available from Compustat; data on political alignment have been collected by Kim, Pantzalis and Park (2012); data on corporate political strategies are from the Center for responsive Politics (CRP); data on House and Senate committees and chairmanships are available on Charles Stewart's Congressional Data website: http://web.mit.edu/17.251/www/data_page.html; analysts' data is obtained from I/B/E/S.

Acknowledgements: We are thankful for helpful comments from two anonymous reviewers, Jung Chul, Henri Dekker, Shane Dikolli, Ralf Ewert, Benedikt Franke, Chansog (Francis) Kim, Clive Lennox, Susanne Preuss, Alfred Wagenhofer, David Windisch, participants at the workshop on the politics of accounting in Amsterdam, the European Accounting Association Annual Conference in Glasgow, and the VHB Annual Meeting in Vienna, seminar participants at the University of Graz, and participants at the ARCA seminar of the VU Amsterdam.

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Abstract

In this study, we apply a new concept, corporate proximity to political power, to accounting research and examine its consequences on corporate financial reporting. Prior literature shows that higher proximity to political power leads to higher policy risk, i.e., uncertainty regarding the impact of future administration policies on the cash flow of the firm. An increase in policy risk implies an increase in the opaqueness of the information environment and in the expected volatility of future operating profitability; we argue that these effects both encourage and facilitate earnings management. Drawing on recent research in finance and political science, we use a measure of the alignment along party lines between politicians elected at the state level and the federally elected President as our main measure of proximity to political power. We find a significant positive association between the political alignment of firms' home states and their level of absolute discretionary accruals. Consistent with the idea that firms engage in corporate political activities (lobbying and financial contributions) to hedge against policy risk, our results only hold for firms not engaging in such activities.

1. Introduction

Does political geography, i.e. the dynamic evolution of the political map as it emerges from federal and state-level elections, matter for financial reporting? Changes in political geography result in exogenous shifts of firms' proximity to powerful politicians. Kim et al. (2012) and Pantzalis and Park (2014) showed that proximity to political power implies greater exposure to uncertainty about the impact of future policy initiatives on firms. Such policy risk can translate into higher cost of equity (Kim et al. 2012) and debt capital (Bradley et al. 2015).[1] In this paper, we posit that, in addition to its potential cost of capital implications, exposure to policy risk can make firms' economic environment more volatile and less transparent, creating both incentives and opportunities for firms to engage in earnings management.

Our analysis introduces a metric of political geography to accounting research by adopting the measure of corporate proximity to political power proposed by Kim et al. (2012) which focuses on the political alignment of firms' home states with the federally elected president. We find that proximity to

[1] Kim et al. (2012) provide evidence on the causal relationship between proximity to political power and risk, by regressing lagged changes in proximity on changes in systematic risk (ΔBeta). They show that the coefficient of (ΔBeta) is positive and significant at the 1% level. Bradley et al. (2015) use the same measure of proximity to political power and find that it is negatively related to corporate bond ratings and positively related to firms' cost of debt.

political power is positively and significantly associated with earnings management, measured by the absolute value of discretionary accruals calculated using the Jones (1991) model as modified by Dechow et al. (1995).

To corroborate the robustness of our results, we employ alternative proxies for both our dependent and independent variables and provide numerous other robustness analyses. The main results remain unchanged when using alternative discretionary accrual models (Jones 1991; Kothari et al. 2005), taking into account exogenous business shocks (Owens et al. 2016), including a more extensive set of control variables and estimating our main regression model in changes. In addition, following the approach proposed by Pincus and Rajgopal (2002), we document that the observed earnings management efforts are partly driven by smoothing considerations. Based on ideology measures taken from Berry et al. (1998), we also calculate two measures of ideological proximity to political power; using these metrics, the results are comparable to the ones obtained with our main measure of proximity to political power.

We furthermore investigate the relation between political geography and earnings management conditional on more direct types of political connectedness. We test whether firms actively pursuing political strategies via lobbying expenditures and contributions to political action committees are different from other firms (i.e., those not politically active but merely relying on passive political connections) when it comes to implications of proximity to political power. Consistent with the idea that actively pursuing corporate political strategies constitutes a hedge against policy risk stemming from exogenous variation in political geography (Bradley et al. 2015), we find that earnings management is not significantly associated with proximity to political power for firms which engage in political strategies but is positively and significantly associated for firms that do not. Taken together, our results strongly suggest that political geography has effects on firms' financial reporting decisions and that more proximity to political power leads to more earnings management. We furthermore document that different forms of political connectedness have different effects on financial reporting outcomes and affect firms' reporting choices in a substitutive manner.

Our results contribute to the literature on the effects of political forces on financial reporting (Watts 1977; Watts and Zimmerman 1978). In recent years, a number of studies have investigated the effects of corporate political connections on the strictness of accounting enforcement, audit quality and earnings quality (Batta et al. 2014; Bliss et al. 2011; Chaney et al. 2011; Correia 2014; Guedhami et al. 2014; Gul 2006). Similarly to Chaney et al. (2011), we use a discretionary-accruals-based measure of earnings management as our dependent variable. Our research goes beyond the existing literature by using a political-geography-based metric of corporate proximity to political power as our independent variable of interest. This measure, in essence, depicts a firm's indirect (or "passive") connectedness that arises from its location in the political map, and which captures the degree of potential exposure to policy risk (Kim et al. 2012). In contrast to other more direct political connectedness proxies used in the accounting literature, ours has the double advantage of being fully exogenous to firms' own decisions and providing us with a large number of observations in the empirical tests. Additionally, it goes beyond the dichotomy of classifying firms as either politically connected or non-connected and accounts for both exposure to policy risk and indirect connectedness.

We furthermore contribute to research on the effects of geography on financial reporting. Geographic proximity has been found to provide informational advantages (Choi et al. 2012; John et al. 2011). Shi et al. (2015) find that geographically dispersed firms engage in more real but less accruals-based earnings management. Kedia and Rajgopal (2011) and DeFond et al. (2011) argue that closeness to a regional office of the Securities and Exchange Commission facilitates supervision by the latter and therefore leads to less reporting misbehavior and more conservative going concern opinions. While the effects of *political* geography have received attention in the finance literature over recent years (e.g., Faccio and Parsley 2009; Kostovetsky 2015; Pantzalis and Park 2014), our study is the first to investigate its consequences for financial reporting.

The remainder of our paper is structured as follows: Section 2 reviews the literature and develops our hypotheses. Section 3 introduces the research design. Section 4 describes our data. Section 5 presents our main empirical results and section 6 gives details on additional analyses. Finally, section 7 concludes.

2. Background and hypothesis development

2.1. Effects of political connectedness on firms' information environment

Over the past 30–40 years more and more firms are choosing to become politically active as a means to better compete in a business landscape that has become entangled with the political one. Politically connected firms have been found to differ from non-connected firms with respect to financial reporting characteristics. Corporate political connections exert an influence on accounting processes via more lenient enforcement (Correia 2014), a lesser reliance of connected firms on the capital market due to better access to credit financing (Leuz and Oberholzer-Gee 2006; Chaney et al. 2011), protection from government expropriation (Batta et al. 2014), effects on statutory audit (Guedhami et al. 2014; Gul 2006) and political costs due to higher visibility of connected firms (Ramanna and Roychowdhury 2010), among others. While the literature on the effects of corporate political connections on financial reporting has grown reasonably broad, potentially differential effects of different forms of connections have not been investigated so far. In a study of the determinants of government bailouts, Duchin and Sosyura (2012) collect data on a broad range of connectedness measures, including geographic as well as financial links between firms and politicians. They find correlations between these measures to be low, indicating that they capture different aspects of political connectedness.

Political connections have ambiguous economic consequences for firms. A number of connectedness advantages have been identified in the literature, including a higher likelihood of being bailed out (Blau et al. 2013; Faccio et al. 2006), better access to bank financing (Claessens et al. 2008; Li et al. 2008), a lower effective tax rate (Adhikari et al. 2006; Wu et al. 2012) and a higher chance of obtaining government procurement contracts (Goldman et al. 2013; Tahoun 2014). At the same time, there is evidence that political connections serve corporate insiders at the detriment of outside investors. Tu et al. (2013) find that politically connected acquirers of privatized firms engage in tunneling. Yu and Yu (2011) find that firms that lobby evade fraud detection, on average, 117 days longer than other firms. Correia (2014) and Fulmer and Knill (2012) find that SEC enforcement tends to be more lenient on firms which contribute to political action committees. Firms' proximity to the political process may additionally expose them to higher policy risk (Bechtel and Füss 2010; Mattozzi 2008) or induce them

to overinvest in order to electorally support the incumbent government (Bertrand et al. 2006; Wu et al. 2012). In a systematic review of the literature on global corporate political activity, Rajwani and Liedong (2015) conclude that, in developed countries, studies find positive as well as negative effects of political connections on firms' operating and capital market performance. Hillman and Hitt (1999) describe corporate political activities as market-like processes where the political quid pro quo consists in politicians supplying public policy and firms providing the political exchange goods: money, information and votes.

Political quid pro quos are likely to depend on some level of secrecy and neither firms nor politicians trading favors are interested in much scrutiny (Ben-Nasr et al. 2015). At the same time, the less strict enforcement of disclosure rules on connected firms facilitates a higher degree of opaqueness. Corporate political connections therefore could lead to higher information uncertainty, defined in terms of the precision with which firm value can be estimated by knowledgeable investors at reasonable cost (Chen et al. 2013; Jiang et al. 2005). Chen et al. (2010) accordingly show that financial analysts forecast earnings of connected firms less accurately than earnings of non-connected firms. Aabo et al. (2015) find that firms located in areas subject to more local political influence are associated with greater comovement with other local stocks and greater levels of excessive preference by local investors (i.e., local bias). Both measures are related to informational frictions in stock market (Barberis et al. 2005; Ivković and Weisbenner 2005). In the accounting literature, political connections are generally found to be positively associated with measures of earnings management (Chaney et al. 2011; Ramanna and Roychowdhury 2010). Connected firms have also been found to suppress the release of bad news before important political events (Piotroski et al. 2015). They appear to pay higher audit fees than non-connected firms, indicating that they are perceived more risky by auditors (Bliss et al. 2011; Gul 2006; Wahab et al. 2011).

2.2. Political geography as a source of corporate political connectedness

The literature on corporate political connections has identified a number of different sources of corporate connectedness to politicians including, inter alia, financial contributions to election campaigns and lobbying expenditures (Correia 2014), top management's past service in government or the military (Wu

et al. 2012) and equity ownership by influential politicians (Faccio 2006; Tahoun 2014). While most of these forms of connectedness result from deliberate corporate actions, firms can also be passively connected to politicians by the effects of political geography. Politicians have electoral motivations to care about the economic condition of their constituency and therefore have incentives to channel national funds to their voting districts (Cohen et al. 2011). Consistent with this explanation, event studies have found negative capital-market reactions upon the news of the unexpected death of a politician for firms located in his or her home state (Faccio and Parsley 2009; Roberts 1990). Studies on determinants of government bailouts during the 2008 financial crisis find that geographic political connections played a role in allocation of assistance under the Troubled Asset Relief Program (Duchin and Sosyura 2012; Kostovetsky 2015). In addition to channeling financial funds to their home states, politicians may also lean on regulatory agencies to provide more lenient treatment to electorally important firms, e.g., those employing a large workforce in their electoral district (Heese 2015).

As is the case with other forms of corporate political connections, indirect connections via proximity to political power stemming from political geography have ambiguous effects. While firms enjoy the benefits described above, they may at the same time be exposed to higher policy risk. Veto player theory (e.g., Tsebelis 2002) argues that a government divided along partisan lines is generally less capable of implementing large policy changes. This implies that financial markets can operate under less policy risk than in times of unified governments (Bechtel and Füss 2008; Fowler 2006). In a federal system such as the United States, a state government which is politically aligned with the federal president will be more likely to fully and quickly implement federal policies whereas states politically opposed to the president may attempt to veto or delay implementation. Consistent with this interpretation of political alignment leading to higher policy risk, Kim et al. (2012) find that political alignment of a firm's home state is significantly associated with higher returns. Pantzalis and Park (2014) show that the effect of geographic proximity to centers of political power is particularly strong in the presence of substantial corruption or dependence on government spending.

2.3. Hypotheses

The preceding discussion suggests that proximity to political power can have a detrimental effect on firms' information environment. It may increase information uncertainty which facilitates earnings management as investors are less able to see through it. At the same time, higher policy risk implies an increase in the expected volatility of future reported earnings. This would in turn lead to an increased risk of violating accounting-based covenants and to less smooth earnings figures being reported to investors. Both effects have been found to motivate earnings management (Dechow and Skinner 2000; Graham et al. 2005; Healy and Wahlen 1999; Schipper 1989). We thus conclude that proximity to political power may both facilitate and encourage earnings management and state our main hypothesis as:

H1: Firms' proximity to political power is positively associated with earnings management.

We note that our argument does not rely on managers consciously taking politics into account when making decisions about accruals. Our argumentation only requires that managers become aware of the profitability consequences of increased policy risk which previous literature has shown to result from proximity to political power.

We are furthermore interested in the interaction of proximity to political power stemming from political geography, a form of indirect political connectedness, and other, direct forms of political connectedness emanating from firms actively pursuing corporate political strategies. There is little research on how these different political connections are related. Antia et al. (2013) argue that firms use political strategies to hedge policy risk and find that they adjust their lobbying expenditures in reaction to changes in political geography. Bradley et al. (2015) investigate the relation of proximity to political power and the cost of debt. They find no significant association for firms engaging in lobbying and/or contributing to PACs; for firms not engaging in such political strategies, they document a significantly positive association. Their results are consistent with the interpretation that firms successfully engage in corporate political strategies to hedge their exposure to policy risk. Based on these considerations, we posit that the effect of proximity to political power may be mitigated for firms lobbying and contributing to PACs and state our second hypothesis as:

H2: The association between proximity to political power and earnings management is less pronounced for firms engaging in corporate political activities.

3. Research Design

3.1. Measuring proximity to political power

In our empirical tests, we focus on one particular setting in which effects of political geography lead to changes in firms' proximity to political power: the political alignment between the federally elected President and politicians elected on a state level along party lines. We use the political alignment index (PAI) developed by Kim et al. (2012) as our measure of proximity to political power. PAI indicates the degree of alignment of state politicians with the President along party lines. PAI is calculated at the state-level and defined as follows:

$$\text{PAI} = \frac{1}{4} \cdot \text{SENATORS} + \frac{1}{4} \cdot \text{REPRESENTATIVES} + \frac{1}{4} \cdot \text{GOVERNOR} + \frac{1}{4} \cdot \left(\frac{1}{2} \cdot \text{STATE SENATORS} + \frac{1}{2} \cdot \text{STATE REPRESENTATIVES} \right)$$

where SENATORS is the percentage of the state's two senators that belong to the President's party; REPRESENTATIVES is the percentage of House representatives that belong to the President's party; GOVERNOR is a dummy variable that equals one if the Governor is in the same party as the President, and zero otherwise; STATE SENATORS is a dummy variable that equals one if the percent of state senators in the President's party is greater than 50%, and zero otherwise; STATE REPRESENTATIVES is a dummy variable that equals one if the percentage of House representatives in the President's party belonging to a given state is greater than 50%, and zero otherwise. PAI is a state-year specific variable; every two years, PAI is updated following presidential and midterm elections.[2]

[2] Gubernatorial elections in a majority of states are held simultaneously with either presidential or midterm elections. Five states (Kentucky, Louisiana, Mississippi, New Jersey and Virginia) hold elections off the federal cycle. To ensure that these states do not drive our results, we repeated our main analysis excluding firms headquartered in one of these five states and obtained qualitatively unchanged results.

We furthermore corroborate our results using two measures of *ideological* proximity to political power, which are based on the ideology indexes developed by Berry et al. (1998; 2010). In particular, we use Berry et al.'s (1998) revised 1960-2013 citizen ideology series, IDEO_CIT, and their ADA/COPE measure of state government ideology, IDEO_GOV. IDEO_CIT (IDEO_GOV) measure the average location of the active electorate (of the elected officials) in each state on a liberal-conservative continuum, with higher values indicating a more liberal orientation. First, to capture the ideological proximity between citizens and the federal government, we use IDEO_CIT times a dummy variable for fiscal year ends that fall into time periods with a Democratic President. We denote this measure as IPFG (ideological proximity to the federal government). Second, similar to Pantzalis and Park (2014), we use these measures to calculate an ideology alignment metric on the state level. Specifically, we compute the absolute value of the distance between IDEO_CIT and the respective state government ideology (IDEO_GOV); we multiply this distance by negative one so that higher values represent a greater alignment of ideologies. We denote this measure as IPSG (ideological proximity to the state government).[3] Both IPFG and IPSG, similarly to PAI, capture the notion that political alignment facilitates policy change and hence leads to policy risk. Therefore, we expect that these variables are positively associated with earnings management.

3.2. Measuring earnings management

We measure earnings management by the absolute value of discretionary accruals (ABSDA), calculated using the Jones (1991) model as modified by Dechow et al. (1995). We estimate the following model for each industry-(we use the Fama-French 48 industry classification based on Fama and French 1997)-year group, excluding industry-year groups with less than 20 observations: $\mathrm{TA} = \beta_1 \left(\frac{1}{\mathrm{ASSETS}}\right) + \beta_2 \Delta\mathrm{REV} + \beta_3 \mathrm{PPE} + \varepsilon$. Then we obtain an estimate of normal accruals (NA) as: $\mathrm{NA} = \widehat{\beta_1} \left(\frac{1}{\mathrm{ASSETS}}\right) + \widehat{\beta_2}(\Delta\mathrm{REV} - \Delta\mathrm{AR}) + \widehat{\beta_3}\mathrm{PPE}$. Discretionary accruals are calculated as TA minus NA. TA is total accruals, calculated as: change in current assets (Compustat ACT) minus change in cash and short-term investments (Compustat CHE) minus change in current liabilities (Compustat LCT) plus change in debt

[3] We also repeated the analysis using Berry et al.'s (2010) nominate measure of state government ideology. The results are qualitatively unchanged.

included in current liabilities (Compustat DLC) plus depreciation and amortization expense (Compustat DP). ΔREV is change in revenues (Compustat REVT); ΔAR is change in accounts receivables (Compustat RECT); PPE is gross property, plant and equipment (Compustat PPEGT). All variables are scaled by beginning of year total assets (ASSETS, obtained as Compustat AT). We assume that a higher level of ABSDA implies a higher level of earnings management.

3.3. Relating proximity to political power and earnings management

We relate earnings management to proximity to political power using the following regression model:

$$\text{ABSDA} = \beta_0 + \beta_1 \text{PAI} + \beta_2 \text{LNSIZE} + \beta_3 \text{BM} + \beta_4 \text{LEV} + \beta_5 \text{LNOC} + \varepsilon$$

ABSDA is our measure of earnings management and PAI is our measure of proximity to political power, calculated at the end of the fiscal year. We choose the control variables following prior literature (e.g., Francis et al. 2004, Francis et al. 2008). LNSIZE is the natural logarithm of market value of equity, calculated as the number of common shares outstanding (Compustat CSHO) times the stock price at the end of the fiscal year (Compustat PRCC_F). BM is the book-to-market ratio, calculated as the book value of equity (Compustat CEQ) divided by the market value of equity at the end of the fiscal year. LEV is calculated as the ratio between total liabilities (Compustat LT) and total assets (Compustat AT). LNOC is the natural logarithm of the operating cycle, calculated as the sum of days accounts receivable and days inventory.[4] Following, for example, Bradley et al. (2015), we include industry-, year- and state-fixed effects and present firm-clustered adjusted standard errors.

4. Dataset and summary statistics

4.1. Data

We obtain the data necessary to calculate the earnings management measures and the control variables from Compustat Annual and Compustat Quarterly. To measure proximity to political power, we use the dataset collected by Kim et al. (2012). We do not include financial firms (SIC 6000–6999). In addition,

[4] Days accounts receivable are calculated as 365 multiplied by the ratio of accounts receivable (Compustat RECT) over sales (Compustat SALE). Days inventory are calculated as 365 multiplied by the ratio of inventory (Compustat INVT) over cost of goods sold (Compustat COGS).

we exclude firm-year observations for which PAI is not available in Kim et al.'s (2012) dataset. PAI is a state-year specific variable, which is updated every two years after presidential and midterm election outcomes; we merge PAI with accounting data, using the available observations at the end of the fiscal year. Firms are matched with state-level PAI based on the location of their corporate headquarter.[5] Table 1 describes the sample selection procedure. The final sample for our main analyses consists of 120,123 firm-year observations for fiscal years from 1966 to 2008, corresponding to 11,038 distinct firms. All continuous variables are winsorized at the 1st and 99th percentile. In additional analyses we use analysts' data from I/B/E/S and data on congressional committees obtained from Charles Stewart's website. Data for our active political strategies variable (POL_ACT), which is based on corporate PAC contributions and lobbying activities, is available from the Center for Responsive Politics (CRP). All variables used for the measurement of ideological proximity to political power are available from Richard Fording's website.[6]

< Insert Table 1 about here >

4.2. Descriptive statistics and cross-correlations

Table 2 reports descriptive statistics for the main variables used in the empirical analysis. ABSDA, our measure of earnings management, has a mean value of 0.1117 and a standard deviation of 0.1729. Our measure of proximity to political power, PAI, has a mean equal to 0.4617 and a standard deviation of 0.2316. Our average sample firm has a market value of equity approximately equal to $ 126.83 Million.

< Insert Table 2 about here >

[5] We follow the procedures in Kim et al. (2012) to determine the geographic location at the end of the fiscal year. Headquarter address information is initially extracted from Compustat; because Compustat indicates only the latest address information, Compact Disclosure is then used to account for address changes. We drop 187,557 observations for which address information is unavailable in Compustat or where there are inconsistencies between the information reported in Compustat and that reported in Compact Disclosure. Our final sample is larger than the final sample in Kim et al. (2012) because we have different requirements concerning the control variables and do not require the availability of monthly stock returns.

[6] See https://rcfording.wordpress.com/state-ideology-data/

Table 3 reports Spearman correlations (above the diagonal) and Pearson correlations (below the diagonal) for the main variables. The correlation between ABSDA and PAI is not significantly different from zero: the Spearman coefficient is equal to -0.0034 and the Pearson coefficient is equal to 0.0087. The different levels of aggregation of ABSDA and PAI (where the former is measured at the firm-year level and the latter at the state-year level) are likely to bias the univariate correlations downwards and to explain the insignificant coefficients. In the multivariate analyses this problem is alleviated since we use state- and year-fixed effects (together with industry-fixed effects and other control variables).

< Insert Table 3 about here >

5. Main Empirical results

5.1. Proximity to political power and earnings management

Table 4 reports the main results of the model relating earnings management to the political alignment of the state where the firm is headquartered. The coefficient on PAI is positive and highly significant; hence, firms located in states that are more closely aligned with the President are more likely to engage in earnings management. Specifically, a one standard deviation increase in PAI is associated with a ~2.28% increase in earnings management. In essence, since the magnitude of one standard deviation of PAI is 0.2316, the aforementioned economic effect can be approximately triggered by a change in party control of just one of the four political components of a state's PAI (i.e., senators, congressmen, governor and state legislature). For example, a shift in control of a state's governorship in favor of the party of the President would, on average, result in a ~2.3% increase in earnings management by firms located in that state. The control variables have the expected signs; in particular, size appears to explain

a high portion of the variation.[7] Overall, these results support H1. Proximity to political power is positively associated with the propensity of managers to manage earnings.[8]

When separately focusing only on positive and negative discretionary accruals, respectively, the results are similar to those obtained from the pooled sample and seem to be stronger, in terms of both a higher magnitude of the coefficient and a higher significance level, in the case of negative discretionary accruals than in the case of positive discretionary accruals.[9] However, testing the differences between the coefficient on PAI in the regressions of column (2) and (3) does not yield significant results. Hence, the results are not consistent with alternative political-costs-related motivations for earnings management that would predict stronger results on downwards (i.e., income-decreasing) earnings management relative to upwards (i.e., income-increasing) earnings management.[10]

< Insert Table 4 about here >

Our analysis is based on the argument that political alignment along partisan lines facilitates policy change and hence makes the policy environment more volatile. A similar effect may be produced by ideological proximity between a state's citizens and the federal government and between a state's citizens and the state's government. To test this conjecture, we repeat our tests using IPFG and IPSG, which are based on Berry et al.'s (1998) ideology indexes. IPFG measures ideology proximity between the state's citizens and the federal government, whereas IPSG measures ideology proximity between the

[7] To further investigate the role of LNSIZE, we also ranked the firm-year observations in quartiles based on LNSIZE and replicated the main analysis for each quartile, separately. The coefficient on PAI is positive in all quartiles; it is significant (at the 10% level) in the first (bottom) quartile, insignificant in the second quartile and significant (at the 1% level) in the third and fourth quartile. Therefore, the significance of the association is higher in the top quartiles than in the bottom quartiles; however, the coefficient on PAI in the bottom quartile is not significantly different than the coefficient on PAI in the top quartile. To control for LNSIZE after partialling out the effect of corporate political strategies, we also double sorted the observations by POL_ACT and then by LNSIZE and find that the results remain qualitatively similar to the quartile-regressions based on LNSIZE.

[8] As described in section 3, PAI is updated every two years following presidential and midterm elections. There are five states which are off the federal election cycle. In order to ensure that our results are not affected by the inclusion of these five states, we ran the same analysis excluding all firm-years in which a firm is headquartered in one of these five states. Our results are qualitatively unaffected by this exclusion.

[9] A number of prior studies use a similar research design and examine the determinants of positive and negative discretionary accruals, separately. See, e.g., Yu (2008).

[10] Watts and Zimmermann (1978) suggest that political costs are one of the key drivers of accounting choices. Under the political-costs hypothesis, firms attempt to defer reporting profits in order to deflect attention away from political decision makers and/or the public (Ramanna and Roychowdhury 2010). As proximity to political power increases policy risk, one could expect that firms with higher political alignment would use income-decreasing earnings management more extensively as part of their overall political strategy.

state's citizens and the state's government. The results, which are reported in Table 5, show that both IPFG and IPSG are positively associated with earnings management. These results are similar to the ones we report in Table 4 and they lend support to our interpretation of our main findings: changes in the political geography, which imply higher proximity to political power, lead to higher earnings management.

< Insert Table 5 about here >

5.2. Corporate political strategies

In this section, we put hypothesis H2 to test by examining a subsample of companies that actively pursue corporate political strategies. To identify this subsample, we look at companies that either lobby or make contributions to PACs. The idea underlying these analyses is that companies that are politically active should have substantially lower incentives to manage earnings, as they are already partially hedged against risk stemming from proximity to political power. Thus, we expect the relation between earnings management and proximity to political power to be less pronounced for politically active firms than for firms that are not politically active.

The lobbying data we use is available from the CRP from 1998. Lobbying data are more comprehensive after the passage of the Lobbying Disclosure Act (LDA) of 1995 that mandates lobbying registrants to file semi-annual reports with the Secretary of the Senate and the Clerk of the House of Representatives. We only use our PAC data whenever we also have lobbying data available, as otherwise we could not be sure whether firms engaged in lobbying activities, even in cases where we know that they did not make PAC contributions. Hence, our analyses that are presented in this subsection are limited to firm-years between 1998 and 2008. In these analyses, our sample size reduces to 29,646 firm-year observations belonging to 5,141 distinct companies. We use the dummy variable POL_ACT that takes the value one in firm-years where a respective firm either lobbies or makes PAC contributions; it takes the value zero if the firm pursues neither of these potential courses of action and if we have information on both PAC contributions and lobbying activities. The descriptive statistics in Table 2

show that only ~15.98% of the 29,646 firm-years with PAC and lobbying data belong to firms actively pursuing political strategies.

Firms' decisions to engage in political activities are possibly affected by their home state's political alignment. We follow two distinct strategies to alleviate concerns related to a potential selection bias. First, following Bradley et al.'s (2015, p. 21) proceedings, we use a propensity score matching (PSM) procedure. For every state-year with enough observations for estimation, we estimate a probit regression of LNSIZE, BM and INDPOLACT (defined as the proportion of firms, in the same industry and fiscal year, which are politically active) on POL_ACT and match firms based on the propensity scores that result from this regression on a one-to-one basis. This procedure yields 4,413 firms that did as well as 4,413 firms that did not engage in political activities.[11] Using PSM to alleviate potential self-selection concerns comes with the advantage of having the same amount of observations available in both the treatment (POL_ACT = 1) and the control group (POL_ACT = 0); thus, PSM allows us to select two subsamples which are not only comparable in terms of the characteristics of the political activity choice but also not driven by the different sample sizes of firms engaging and not engaging in political activities. We report the PSM results in columns (1) and (2) of Table 6.

Second, we also apply a two-stage Heckman (1979) model to counter potential criticism related to self-selection in our analyses of firms (not) engaging in political actions. We use the same selection equation that we also use for our PSM and report the results of the second-stage regression in columns (3) and (4) of Table 6.[12]

< Insert Table 6 about here >

Both using the Heckman model as well as PSM, we find that the relation between proximity to political power and earnings management is only significant for firms that are *not* politically active

[11] We note that the PSM procedure, which matches firms on a one-to-one basis by state and fiscal year, leads to the loss of some observations for which data on political activity are available. The Heckman model, which we use as an alternative approach, uses all the observations for which data on political activity are available.

[12] The coefficient of the inverse Mills ratio is omitted from columns (3) and (4). It is equal to 0.148 (t-value 4.52) for politically active firms and it is equal to -0.028 (t-value -1.80) for politically inactive firms.

(POL_ACT = 0). The coefficient on PAI is highly significant in columns (2) and (4) but insignificant in columns (1) and (3). Overall, the analysis in Table 6 confirms H2 by showing that the association between proximity to political power and earnings management is not statistically significant if firms actively pursue political strategies.

6. Additional analyses

In this section we present additional analyses and robustness checks to the main results presented in the preceding section.

6.1. Alternative specification of the main model

We consider an alternative specification of our main regression model in which we add further control variables. To further control for the effect of financial weaknesses on reporting incentives, we also repeat the analysis for profit firms and loss firms, separately. The results of the main (alternative) specification are reported in the first two (last three) columns of Table 7.

In the alternative specification, additionally to LNSIZE, BM, LEV and LNOC, we include 12 further control variables. Following Francis et al. (2008), we add the following six control variables: the standard deviation of cash flow from operations (obtained as net income before extraordinary items, Compustat IB, minus total accruals, as defined in section 3), scaled by prior year total assets (Compustat AT), from year $(t-3)$ to year t; the standard deviation of sales (Compustat SALE), scaled by prior year total assets (Compustat AT), from year $(t-3)$ to year t; the frequency of negative earnings, measured as net income before extraordinary items (Compustat IB), from year $(t-3)$ to year t; capital intensity, measured as the ratio of net property, plant and equipment (Compustat PPENT) divided by total assets (Compustat AT); intangible intensity, measured as the sum of reported R&D expense (Compustat XRD) and advertising expense (Compustat XAD) divided by sales (Compustat SALE), with R&D and advertising expenses being set to zero if absent; a dummy variable for absence of intangibles. Furthermore, we add: the Altman's Z score[13] to control for financial weaknesses of the firm; the total

[13] The Altman's Z-score is obtained as: $Z = 1.2 \times$ WC/AT + $1.4 \times$ RE/AT + $3.3 \times$ NIBE + $0.6 \times$ MVE/TL + REV/AT; where WC is working capital (Compustat WCAP); RE is retained earnings (Compustat RE); NIBE is net income before extraordinary

tax expense (Compustat TXT), scaled by prior year total assets (Compustat AT), to control for taxation effects on reporting incentives; Tobin's Q[14] to control for investment opportunities; cash flow from operations, to further control for real activities; a dummy variable for financial statements audited by Big 5 audit firms, calculated using data on the audit firm (Compustat AU) to control for the quality of auditing. Finally, we also add the antitakeover index developed by Bebchuk and Cohen (2003)[15] to further control for corporate governance effects on earnings management choices. The antitakeover index measures the antitakeover protections offered to firms by a state. It is defined so that it increases with the level of protection. The index is calculated at state-year level and we merge the data with our dataset using the index corresponding to the end of the fiscal year.

The results show that with all models and in all subsamples, inferences regarding the association between PAI and earnings management are unchanged. We note that that there is a significant loss of observations with the alternative specification; this is due to the availability of data on some of the additional control variables.

< Insert Table 7 about here >

To further control for regulatory differences across industries, we repeat the analysis by excluding 11 industries which are highly regulated (the industries are selected based on the Fama and French classification): Agriculture; Tobacco Products; Healthcare; Pharmaceutical Products; Defense; Precious Metals; Non-Metallic and Industrial Metal Mining; Coal; Petroleum and Natural Gas; Utilities; and Communication. The results, which are untabulated, are unchanged relative to the main analysis (we ran the regression with 100,948 observations; the coefficient of PAI is equal to 0.013; the t-value is equal to 4.71).

items (Compustat IB); MVE is the market value of equity (Compustat PRCC_F multiplied by Compustat CSHO); TL is total liabilities (Compustat LT); REV is revenues (Compustat REVT) and AT is total assets (Compustat AT).

[14] Tobin's Q is calculated as: TQ = (MVE+BVL)/(BVE+BVL); where MVE is market value of equity (Compustat CSHO times Compustat PRCC_F); BVL is book value of liabilities (Compustat LT); BVE is book value of equity (Compustat CEQ).

[15] The data are obtained from Lucian Bebchuk's webpage at the following URL: http://www.law.harvard.edu/faculty/bebchuk/data.shtml.

6.2. Corroborating the earnings management metric

To alleviate the concern that our results are driven by a particular specification of our discretionary accruals model, we replicate the main analysis using two alternative discretionary accrual models. First, we use the original Jones (1991) model;[16] second, similar to Kothari et al. (2005), we include ROA in the Dechow et al. (1995) model.[17] The results are untabulated. With both models, inferences regarding the association between PAI and ABSDA are unchanged. Using the original Jones (1991) model, the coefficient on PAI is positive (0.0123) and significant with a t-value of 4.80. For the Dechow et al. (1995) model with ROA included, the PAI coefficient takes the value of 0.009 and is significantly different from zero with a t-value of 3.61.

Furthermore, abnormal accruals models have been subject to frequent criticism in the literature (e.g., Dechow et al. 2010, Owens et al. 2016). One of the main points of criticism is that abnormal accruals are also affected by business shocks, and therefore may sometimes provide only a rough proxy of managerial discretion used in reporting accruals. In order to mitigate the concern on the inability of abnormal accrual models to distinguish the discretionary component of accruals from the effect of business shocks, we repeat the analysis by excluding firm-year observations which are likely to be associated with business shocks. Following Owens et al. (2016), we exclude the obvervations with: (1) major acquisitions (Compustat SALE_FN = "AB"); (2) large discontinued operations (discontinued operations greater than five percent of sales, i.e., Compustat DO divided by Compustat SALE > 0.05); (3) four-digit SIC industry changes; (4) large restructuring charges (restructuring charges greater than five percent of sales, i.e., Compustat RCP divided by Compustat SALE > 0.05); (5) large special items (special items greater than five percent of sales, i.e., Compustat SPI divided by Compustat SALE >

[16] Following Jones (1991), we estimate the following model for each industry (we use the Fama-French 48 industry classification)-year group, excluding industry-year groups with less than 20 observations: $\mathrm{TA} = \beta_1\left(\frac{1}{\mathrm{ASSETS}}\right) + \beta_2\Delta\mathrm{REV} + \beta_3\mathrm{PPE} + \varepsilon$. TA is total accruals, calculated using the balance sheet method (see section 3); ΔREV is change in revenues (Compustat REVT); PPE is gross property, plant and equipment (Compustat PPEGT). All variables are scaled by beginning of year total assets (ASSETS, obtained as Compustat AT). Discretionary accruals are obtained as the estimated residuals.

[17] Following, e.g., Kothari et al. (2005), we control for performance in the expected accrual model. We estimate the following model for each industry (we use the Fama-French 48 industry classification)-year group, excluding industry-year groups with less than 20 observations: $\mathrm{TA} = \beta_1\left(\frac{1}{\mathrm{ASSETS}}\right) + \beta_2\Delta\mathrm{REV} + \beta_3\mathrm{PPE} + \beta_4\mathrm{ROA} + \varepsilon$. Then we obtain an estimate of normal accruals (NA) as: $\mathrm{NA} = \widehat{\beta_1}\left(\frac{1}{\mathrm{ASSETS}}\right) + \widehat{\beta_2}(\Delta\mathrm{REV} - \Delta\mathrm{AR}) + \widehat{\beta_3}\mathrm{PPE} + \widehat{\beta_4}\mathrm{ROA}$. Discretionary accruals are calculated as TA – NA. TA is total accruals, calculated as using the balance sheet method (see section 3); ΔREV is change in revenues (Compustat REVT); PPE is gross property, plant and equipment (Compustat PPEGT); ROA is obtained as net income before extraordinary items scaled by end of year total assets (Compustat AT). All variables, except ROA (which is calculated using year-end total assets, are scaled by beginning of year total assets (ASSETS, obtained as Compustat AT).

0.05). Excluding those observations leads to the loss of 12.23% of the sample; despite the reduction in the number of observations, the results, which are untabulated, are qualitatively similar to the main analysis (the coefficient on PAI is equal to 0.009, the corresponding t-value is 3.57). This suggests that our findings are not driven by business shocks which are unrelated to discretionary reporting choices and lends further credibility to our main results.

6.3. Proximity to political power and earnings management aimed at smoothing

One of the underlying objectives of the earnings-management effects that we document might be managers' desire to report smooth earnings (e.g., Ronen and Yaari 2008). Trueman and Titman (1988) argue that uncertainty about firms' underlying operations gives rise to incentives for opportunistic income smoothing. To investigate whether proximity to political power is associated with earnings management aimed at smoothing we use the 'smoothing with discretionary accruals ratio' (SMR) proposed by Pincus and Rajgopal (2002).[18] We also consider a broader measure of earnings smoothing, which reflects both the discretionary and non-discretionary smoothing portion, which we denote as SMQ.[19] However, the focus of this robustness analysis is on SMR, because SMQ reflects both the non-discretionary and the discretionary portion of smoothing, while SMR only focuses on the discretionary part. We repeat our main analysis, now using SMQ and SMR as dependent variables, respectively. The results are reported in Table 8. For SMR, consistent with the results described above, the coefficient on PAI is positive and significantly different from zero; for SMQ, the coefficient on PAI is not significantly

[18] Pincus and Rajgopal (2002) empirically test and find oil and gas firms to use abnormal accruals and hedging with derivatives as substitutes to manage earnings volatility (see also Barton 2001). SMR is defined as follows: $\text{SMR} = \sigma(\text{NIBACQ})/\sigma(\text{NIBEQ})$, where σ refers to the standard deviation calculated over the fiscal year. NIBEQ is net income before extraordinary items (Compustat IBQ) scaled by prior quarter total assets (Compustat ATQ). NIBACQ stands for quarterly net income before extraordinary items and discretionary accruals, which is obtained as quarterly cash flow from operations plus quarterly non-discretionary accruals. Quarterly cash flow from operations is obtained as quarterly net income before extraordinary items (Compustat IBQ) minus quarterly total accruals. Quarterly total accruals is calculated as: change in quarterly current assets (Compustat ACTQ) minus change in quarterly cash and short-term investments (Compustat CHEQ) minus change in quarterly current liabilities (Compustat LCTQ) plus change in quarterly debt included in current liabilities (Compustat DLCQ) plus quarterly depreciation and amortization expense (Compustat DPQ). All variables are scaled by beginning of quarter total assets (ASSETSQ, Compustat ATQ). Consistent with the analysis on annual level, to estimate the quarterly discretionary portion of accruals we use the Dechow et al. (1995) model. Specifically, we estimate the following model for each industry (we use the Fama-French 48 industry classification)-year-quarter group, excluding industry-year-quarter groups with less than 20 observations: $\text{TAQ} = \beta_1\left(\frac{1}{\text{ASSETSQ}}\right) + \beta_2\Delta\text{REVQ} + \beta_3\text{PPEQ} + \varepsilon$. Then we obtain an estimate of normal accruals (NAQ) as: $\text{NAQ} = \widehat{\beta_1}\left(\frac{1}{\text{ASSETSQ}}\right) + \widehat{\beta_2}(\Delta\text{REVQ} - \Delta\text{ARQ}) + \widehat{\beta_3}\text{PPEQ}$. Quarterly discretionary accruals are calculated as TAQ minus NAQ. ΔREVQ is change in revenues (Compustat REVTQ); ΔARQ is change in accounts receivables (Compustat RECTQ); PPEQ is gross property, plant and equipment (Compustat PPEGTQ). All variables are scaled by beginning of quarter total assets (ASSETSQ). A higher value SMR indicates greater use of discretionary accruals aimed at smoothing reported earnings.

[19] SMQ is defined as follows: $\text{SMQ} = \sigma(\text{CFOQ})/\sigma(\text{NIBEQ})$; where CFOQ is quarterly cash flow from operations. A higher value of SMQ indicates smoother earnings.

different from zero. These results lend support to the view that, as policy risk increases with proximity to political power, managers use discretionary accruals choices to smooth earnings. These findings shed more light on the association between earnings management and proximity to political power and suggest that it is partly driven by smoothing-motivated earnings management.

< Insert Table 8 about here >

6.4. Committee chairmanships

Observers of the federal policy-making process in the United States emphasize the role of Congressional committees and the importance of their chairmen's agenda-setting powers (e.g., Roberts 1990; Shepsle 1989). This agenda-setting power gives chairmen an important influence over the outcome of the legislative process (Shepsle and Weingast 1981; Walker 1977). Cohen et al. (2011) find that chairmen of important committees earmark public spending for their home states, crowding out private investment. A change in chairmanship of an influential committee involving a politician from a given state may therefore have implications for firms from that state which are difficult to predict.

We obtain data on the composition of Congressional committees from Charles Stewart's website[20] and follow Stewart (2012) in identifying the ten most influential committees.[21] We consider all chairmen and ranking minority members with considerable influence in House and Senate committees.[22] In our committee analyses, we proceed as follows: At the end of each month and for each state, we identify the number of relevant committee members at the House and at the Senate. For each fiscal year and state we build a dummy variable, denoted as CHAIRMEN, which is equal to one if there has been a change in the number of influential committee members from the particular state during the fiscal year and zero if there has not been any change to this number. Using this variable, we estimate

[20] Information on committee members at the House and at the Senate is available at the website http://web.mit.edu/17.251/www/data_page.html. From the database we extract the following data regarding committee members: name, state, date of appointment and termination, party, role in the committee.

[21] Specifically, for the Senate, the ten most influential committees are: Finance, Veterans Affairs, Appropriations, Rules, Armed Services, Foreign Relations, Intelligence, Judiciary, Budget, and Commerce. For the House, these committees are: Ways and Means, Appropriations, Energy and Commerce, Rules, International Relations, Armed Services, Intelligence, Judiciary, Homeland Security, and Transportation and Infrastructure. Our results are similar if we focus on the five or on the three most influential committees or consider all committees.

[22] Our results are robust to changes on the definition of influential committee members. If we exclude all ranking minority members, e.g., we obtain very similar results.

our main model on the relation between proximity to political power and earnings management for observations where CHAIRMEN is equal to one and zero separately. These results are reported in columns (1) and (2) of Table 9. In column (3) of Table 9, we also interact CHAIRMEN with the other variables in the main model.

< Insert Table 9 about here >

The analysis in Table 9 indicates that the effect of PAI on earnings management is significantly stronger in states in which there has been a change in the number of holdings of influential chairmanships. This result is consistent with the interpretation that changes in influential committee chairmanships create additional risk for firms of the respective state which adds to the effect of political alignment.

6.5. Effects of temporal distance to election

In this section, we examine whether the strength of the association between PAI and earnings management varies across time. Uncertainties about future policies are partly resolved by elections, which means that the effect of proximity to political power which we conjecture to affect earnings management via policy risk may vary over the electoral cycle. We therefore investigate the effect of PAI on earnings management during different parts of the electoral cycle. In particular, we investigate whether the effects of political alignment on earnings management are different in: election years; presidential election years; post-midterm-election years; individual years over the presidential election cycle; and short periods around presidential elections. To do this, we build a set of dummy variables that take value one when the end of the fiscal year corresponds to the above time periods and zero otherwise. For each period analyzed, we then include the dummy variable in our main model and we interact it with all the independent variables. We report the results of these tests in Table 10, which also presents the coefficients obtained when estimating the main model in the single periods, separately. Our analysis shows some evidence that the effect of home state political alignment on firms' earnings management choices becomes stronger in periods preceding presidential elections and abates thereafter. The association between earnings management and proximity to political power, as measured by the

coefficient on the interaction term between PAI and the dummy for the period considered, tends to be stronger in periods before elections; however, the interaction term is significantly different from zero only in some of the periods considered.

< Insert Table 10 about here >

6.6. Proximity to political power and volatility of future operating profitability

To bring further support to the view that political alignment is connected to increased (policy) risk we tabulate analyses that relate political alignment to the volatility of firms' future operating profitability in Table 11. We measure volatility of future operating profitability by the standard deviation, calculated over the next three fiscal years, of cash flow from operations, scaled by prior year total assets. We regress PAI, the control variables used in the main model (LNSIZE, BM, LEV and LNOC) as well as further control variables similar to Subramanyam (1996)[23] on volatility of future operating profitability. The coefficient on PAI is positive (0.004) and significantly different from zero (t-value: 2.76). This result supports the view that PAI induces policy risk and that higher levels of political alignment imply a higher volatility of operating profitability in the future.

< Insert Table 11 about here >

6.7. Model in changes

We estimate our main model (that is presented in column (1) of Table 4) in changes, where both the dependent variable and the independent variables are the changes from year $t-1$ to t. The results are untabulated. In this regression, the coefficient on the change in PAI is positive (0.011) and highly significant (t-value: 3.32). These findings provide further support for the documented positive association between proximity to political power and earnings management.

[23] The further control variables that we use are: cash flow from operations, (signed) discretionary accruals and non-discretionary accruals (all as defined in section 3.2).

6.8. Tests of the informativeness of earnings management

We investigate the informativeness of earnings management associated with PAI by examining whether the predictive ability of discretionary accruals with respect to future operating profitability is related to PAI. Specifically, following Subramanyam (1996), we regress future cash flow from operations or net income before extraordinary items (in the first, second and third year after the current fiscal year) on current discretionary accruals (as well as current non-discretionary accruals and current cash flows from operations) and we interact all explanatory variables with PAI. The results are untabulated.[24] Similar to Subramanyam (1996), we find that the coefficient on discretionary accruals is positive and highly significant. However, the coefficient on the interaction term of discretionary accruals and PAI is not significantly different from zero in five out of six models; it is significantly (at the 10%) different from zero (and negative) only when using cash flow from operations in the following year as the dependent variable. The results on these interaction term suggest that earnings management associated with PAI is neither more nor less informative than other earnings management choices.

7. Conclusions

In this paper we examine whether exogenously determined corporate proximity to political power, as reflected in political alignment between politicians of a firm's home state and politicians on the federal level, has an influence on corporate earnings management. Prior research has argued that such political alignment increases policy risk by diminishing gridlock which prevents policy change (Kim et al. 2012). This creates additional uncertainty in a firm's information environment, which both encourages and facilitates earnings management. We test this argument by investigating the relation between a measure of political alignment and the absolute level of firms' discretionary accruals, our measure of earnings management. The analysis covers 120,123 firm-year observations from 11,038 distinct firms from all U.S. states over the 1966 to 2008 period.

[24] Following Subramanyam (1996), we estimate the following model: $\mathrm{OP}_{t+k} = \beta_0 + \beta_1 \mathrm{CFO}_t + \beta_2 \mathrm{NDA}_t + \beta_3 \mathrm{DA}_t + \beta_4 \mathrm{PAI}_t + \beta_5 \mathrm{CFO}_t \times \mathrm{PAI}_t + \beta_6 \mathrm{NDA}_t \times \mathrm{PAI}_t + \beta_7 \mathrm{DA}_t \times \mathrm{PAI}_t + \varepsilon_t$ where CFO is cash flow from operations, scaled by prior year total assets; NDA is non-discretionary accruals; DA is discretionary accruals; OP is a measure of operating profitability (either net income before extraordinary items or cash flow from operations), scaled by prior year total assets. We estimated the model for k = 1, 2, 3. In all the models β_3 is positive and significantly different from zero. β_7 is significantly different from zero (it is negative and significant and the 10% level) only for k = 1 and OP = CFO.

Our results indicate a positive association between proximity to political power and earnings management. We furthermore find that this association only holds for firms which do not engage in lobbying or make financial contributions to PACs. Prior research has shown that firms use such political strategies as a hedge against policy risks (e.g., Kim et al. 2014). In line with these earlier findings, we conclude that our results are indeed driven by the higher policy risk in politically aligned states. We furthermore document a similar effect using a measure of ideological alignment between a state's citizens and respectively their state's government and the federal president.

Our results are related to Chaney et al.'s (2011) findings that firms whose owners or top directors are themselves politicians or are tightly related to high-ranking politicians have significantly poorer earnings quality. They argue that these firms can afford lower earnings quality since they have privileged access to finance and are therefore less subject to capital-market pressures. Such advantages predominantly occur in institutionally less developed countries where political connections compensate for weak public institutions (Claessens et al. 2008; Li et al. 2008). Prior evidence from the U.S. suggests that in this country rent-seeking from personal connections to politicians is impeded by strong institutions (Fisman et al. 2012). Our evidence identifies a different channel through which the proximity to political power created by firms' home states' political alignment has a detrimental effect on their reporting quality: it affects managers' reporting incentives via its effect on policy risk—even in an institutionally strong environment like the U.S.

The findings of this study suggest that political geography plays a role in explaining financial reporting outcomes also within a single country representing a homogenous institutional environment for accounting. It contributes to an emerging literature on the effects of politics on financial reporting by identifying a setting in which changes in the corporate political environment are exogenous. Future research could investigate whether other measures of political geography, e.g., politicians' hometown bias (Faccio and Parsley 2009), lead to similar conclusions with respect to financial reporting decisions at the firm level. The potential relation between the cost of capital effects of political alignment documented in Kim et al. (2012) and the financial reporting effects analyzed here constitutes a further avenue for future research.

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Appendix A: Main variable definitions (in alphabetical order)

Variable	Definition
ABSDA	Absolute value of discretionary accruals (DA). DA are obtained following Dechow et al. (1995). Specifically, we estimate the following model for each industry (we use the Fama-French 48 industry classification)-year group, excluding industry-year groups with less than 20 observations: $\mathrm{TA} = \beta_1\left(\frac{1}{\mathrm{ASSETS}}\right) + \beta_2\Delta\mathrm{REV} + \beta_3\mathrm{PPE} + \varepsilon$. Then we obtain an estimate of normal accruals (NA) as: $\mathrm{NA} = \widehat{\beta_1}\left(\frac{1}{\mathrm{ASSETS}}\right) + \widehat{\beta_2}(\Delta\mathrm{REV} - \Delta\mathrm{AR}) + \widehat{\beta_3}\mathrm{PPE}$. Discretionary accruals are calculated as DA = TA – NA. TA is total accruals, calculated as: change in current assets (Compustat ACT) minus change in cash and short-term investments (Compustat CHE) minus change in current liabilities (Compustat LCT) plus change in debt included in current liabilities (Compustat DLC) plus depreciation and amortization expense (Compustat DP). ΔREV is change in revenues (Compustat REVT); ΔAR is change in accounts receivables (Compustat RECT); PPE is gross property, plant and equipment (Compustat PPEGT). All variables are scaled by beginning of year total assets (ASSETS, obtained as Compustat AT).
BM	Book to market ratio, calculated as book value of equity (Compustat CEQ) divided by the market value of equity at the end of the fiscal year. Market value of equity is obtained as the number of common shares outstanding (Compustat CSHO) times the stock price at the end of the fiscal year (Compustat PRCC_F).
CFO	CFO is used as proxy for operating profitability and stands for cash flows from operations. It is calculated indirectly as income before extraordinary items (Compustat IB) minus total accruals. Total accruals is calculated as: change in current assets (Compustat ACT) minus change in cash and short-term investments (Compustat CHE) minus change in current liabilities (Compustat LCT) plus change in debt included in current liabilities (Compustat DLC) plus depreciation and amortization expense (Compustat DP).
IPFG	Berry et al.'s (1998) citizen ideology index multiplied with a dummy variable that becomes one for time periods with a Democrat President.
IPSG	The absolute value of the difference between Berry et al.'s (1998) revised 1960-2013 citizen ideology series and the ADA/COPE measure of state government ideology (also from Berry et al., 1998) multiplied with negative one.
LEV	Leverage, calculated as the ratio between total liabilities (Compustat LT) and total assets (Compustat AT).
LNOC	Natural logarithm of operating cycle. Operating cycle is calculated as the sum of days accounts receivable and days inventory. Days accounts receivable are calculated as 365 multiplied by the ratio between accounts receivable (Compustat RECT) and sales (Compustat SALE). Days inventory are calculated as 365 multiplied by the ratio between inventory (Compustat INVT) and cost of goods sold (Compustat COGS).
LNSIZE	Natural logarithm of market value of equity. Market value of equity is calculated as the number of common shares outstanding (Compustat CSHO) times the stock price at the end of the fiscal year (Compustat PRCC_F).
PAI	$\mathrm{PAI} = \frac{1}{4}\cdot\mathrm{SENATORS} + \frac{1}{4}\cdot\mathrm{REPRESENTATIVES} + \frac{1}{4}\cdot\mathrm{GOVERNOR} + \frac{1}{4}\cdot\left(\frac{1}{2}\cdot\mathrm{STATE\ SENATORS} + \frac{1}{2}\cdot\mathrm{STATE\ REPRESENTATIVES}\right)$ where SENATORS is the percentage of the two senators that belong to the President's party. REPRESENTATIVES is the percentage of House representatives that belong to the President's party. GOVERNOR is a dummy that equals one if the Governor is in the same party as the President, and zero otherwise. STATE SENATORS is a dummy that equals one if the percent of state senators in the

	President's party is greater than 50%, and zero otherwise. STATE REPRESENTATIVES is a dummy that equals one if the percent of state House representatives in the President's party is greater than 50%, and zero otherwise.
POL_ACT	POL_ACT is a dichotomous variable that becomes one if firms actively pursue corporate political strategies. Corporate political actions that we observe are lobbying and PAC contributions. Both of these data items are available from the CRP and have been collected by Bradley et al. (2015). POL_ACT becomes one if a company engaged in lobbying or made PAC contributions and if we are able to observe both lobbying and PAC contributions. As the lobbying data are only available from 1998 to 2008, the analyses using POL_ACT are limited to this time period as well.

All continuous variables are winsorized at the 1%-level.

Appendix B: Tables

Table 1
Sample selection procedure for our main sample

	firm-years excluded	firm-years remaining	firms remaining
Data initially available in Compustat	/	439,156	34,848
– remaining duplicate firm-years	87	439,069	34,848
– remaining firm-years with SIC code starting with 6	89,751	349,318	26,751
– remaining firm-years with PAI missing	187,557	161,761	14,634
– remaining firm-years with our discretionary accruals measure missing	16,153	145,608	13,627
– remaining firm-years with our control variables missing (i.e., LNSIZE, BM, LEV and LNOC)	25,485	120,123	11,038
= Main sample		**120,123**	**11,038**

BM is the book value of equity over the market value of equity. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. LNSIZE is the natural logarithm of the market value of equity. PAI is our measure of proximity to political power; PAI is missing if the geographic location of the firm at the end of the fiscal year cannot be identified using Compustat and Compact Disclosure (see Section 4.1). POL_ACT is our proxy for active corporate political strategies. SIC is the abbreviation for the Standard Industrial Classification code. More detailed variable descriptions are listed in Appendix A.

Table 2
Variable distributions

	Obs.	Mean	Std. Dev.	p(0.05)	p(0.25)	Median	p(0.75)	p(0.95)
ABSDA	120,123	0.1117	0.1729	0.0044	0.0234	0.0568	0.1237	0.3981
BM	120,123	0.7926	0.7115	0.0828	0.3336	0.6079	1.0433	2.2163
CFO	120,123	0.0257	0.2244	-0.3529	-0.0084	0.0690	0.1295	0.2522
IPSG	120,123	-14.9215	10.3448	-35.2560	-22.5179	-12.4101	-6.4211	-1.6862
LEV	120,123	1.3787	2.3535	0.1157	0.4703	0.9692	1.7581	4.4986
LNOC	120,123	4.8429	0.6842	3.5937	4.4801	4.9087	5.2808	5.8295
LNSIZE	120,123	4.4174	2.1430	1.1569	2.8069	4.2460	5.9038	8.2084
PAI	120,123	0.4617	0.2316	0.0938	0.2917	0.4671	0.6394	0.8750
POL_ACT	29,646	0.1598	0.3664	0.0000	0.0000	0.0000	0.0000	1.0000
ABSDA	120,123	0.1117	0.1729	0.0044	0.0234	0.0568	0.1237	0.3981

ABSDA is the absolute value of discretionary accruals which we estimated using the modified Jones model introduced by Dechow et al. (1995). BM is the book value of equity over the market value of equity. CFO is used as our proxy for operating profitability and calculated as income before extraordinary items minus total accruals. IPFG is our measure of ideological proximity to the federal government. IPSG is our measure of ideological proximity to the state government. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. LNSIZE is the natural logarithm of the market value of equity. PAI is our measure of proximity to political power. POL_ACT is our proxy for active corporate political strategies. SIC is the abbreviation for the Standard Industrial Classification code. More detailed variable descriptions are listed in Appendix A.

Table 3
Pearson and Spearman correlations

	ABSDA	BM	CFO	IPFG	IPSG	LEV	LNOC	LNSIZE	PAI	POL_ACT
ABSDA	**1**	-0.1107*	-0.0860*	-0.0144	0.0052	-0.0970*	0.0768*	-0.1239*	0.0023	-0.0768*
BM	-0.1406*	**1**	-0.0717*	0.0198*	-0.0358*	0.1008*	0.0029	-0.3735*	-0.0009	-0.0860*
CFO	-0.2965*	0.0966*	**1**	-0.0392*	0.0047	0.0179	-0.2455*	0.3312*	0.0598*	0.1034*
IPFG	0.0200*	-0.0736*	-0.0457*	**1**	0.0887*	0.0067	0.0815*	-0.0940*	0.0631*	-0.0791*
IPSG	-0.0512*	0.0599*	0.0183*	-0.0761*	**1**	-0.0377*	0.0176	0.0041	-0.0168	0.0166
LEV	-0.0131*	0.0517*	-0.0033	-0.0081	-0.0149*	**1**	-0.2378*	0.1401*	0.0537*	0.1654*
LNOC	0.0769*	-0.0076	-0.2450*	-0.0017	0.0557*	-0.0883*	**1**	-0.1349*	-0.0493*	-0.0898*
LNSIZE	-0.0495*	-0.3788*	0.1943*	0.0765*	-0.1299*	-0.0111*	-0.1210*	**1**	0.0346*	0.3983*
PAI	0.0087	-0.0075	0.0119*	0.2382*	-0.0316*	-0.0033	-0.0185*	0.0278*	**1**	0.0078
POL_ACT	-0.0428*	-0.0858*	0.0901*	-0.0805*	0.0157	0.0707*	-0.0700*	0.4147*	0.0074	**1**

* indicates Bonferroni-adjusted significance levels of 0.05 or less.

Under the diagonal of the correlation matrix (which is highlighted for better visibility) pairwise Pearson correlations are depicted, above the diagonal Spearman correlations are to be found.

ABSDA is the absolute value of discretionary accruals which we estimated using the modified Jones model introduced by Dechow et al. (1995). BM is the book value of equity over the market value of equity. CFO is used as our proxy for operating profitability and calculated as income before extraordinary items minus total accruals. IPFG is our measure of ideological proximity to the federal government. IPSG is our measure of ideological proximity to the state government. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. LNSIZE is the natural logarithm of the market value of equity. PAI is our measure of proximity to political power. POL_ACT is our proxy for active corporate political strategies. SIC is the abbreviation for the Standard Industrial Classification code. More detailed variable descriptions are listed in Appendix A.

Table 4
Association between proximity to political power and earnings management

	(1) All	(2) upwards EM	(3) downwards EM
PAI	**0.011*** **	**0.010*** **	**0.012*** **
	[4.21]	**[2.80]**	**[3.73]**
LNSIZE	-0.012***	-0.012***	-0.012***
	[-34.32]	[-24.27]	[-31.06]
BM	-0.031***	-0.036***	-0.026***
	[-31.33]	[-25.32]	[-23.19]
LEV	0.001**	0.001**	0.000
	[2.28]	[2.45]	[1.29]
LNOC	0.014***	0.041***	-0.018***
	[9.91]	[21.11]	[-10.73]
Obs.	120,123	60,183	59,940
Adj. R^2	0.142	0.164	0.158

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In all regressions presented in this table, the dependent variable is the absolute value of discretionary accruals. To estimate discretionary accruals, we use the modified Jones model introduced by Dechow et al. (1995). All regression models are estimated with industry-, year- and state-fixed effects and with standard errors that are clustered by firm. The regression F-test (untabulated) is significant at the 1% level in all the models.

In regressions (2) and (3), we estimate the regression model established in regression (1) separately for firms with positive and negative discretionary accruals. Here, 'upwards EM' stands for the analyses on firms having positive discretionary accruals, while 'downwards EM' stands for the analyses on firms having negative discretionary accruals.

PAI is our measure of proximity to political power. LNSIZE is the natural logarithm of the market value of equity. BM is the book value of equity over the market value of equity. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. More detailed variable descriptions are listed in Appendix A.

Table 5

Association between measures of ideological proximity to political power and earnings management

	(1) IPFG	(2) IPSG
IDEOLOGICAL PROXIMITY	**0.002** **[2.24]**	**0.001** **[2.04]**
LNSIZE	-0.012*** [-34.29]	-0.012*** [-34.27]
BM	-0.031*** [-31.28]	-0.031*** [-31.29]
LEV	0.001** [2.27]	0.001** [2.29]
LNOC	0.014*** [9.90]	0.014*** [9.89]
Const.	0.060 [1.42]	0.061 [1.45]
Obs.	120,123	120,123
Adj. R^2	0.142	0.142

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In all regressions presented in this table, the dependent variable is the absolute value of discretionary accruals. To estimate discretionary accruals, we use the modified Jones model introduced by Dechow et al. (1995). All regression models are estimated with industry-, year- and state-fixed effects and with standard errors that are clustered by firm. The regression F-test (untabulated) is significant at the 1% level in all the models.

Our main independent variables in the above analyses are: (1) IPFG, i.e., our measure of ideological proximity to the federal government; (2) IPSG, i.e., our measure of ideological proximity to the state government. The coefficients on IPFS and IPSG have been multiplied by 10.

LNSIZE is the natural logarithm of the market value of equity. BM is the book value of equity over the market value of equity. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. More detailed variable descriptions are listed in Appendix A.

Table 6

Results on the substitutional effects of earnings management and corporate political strategies to hedge against proximity to political power

	matched sample (propensity score matching)		unmatched sample (Heckman procedure)	
	(1) POL_ACT = 1	(2) POL_ACT = 0	(3) POL_ACT = 1	(4) POL_ACT = 0
PAI	**0.001**	**0.040****	**0.000**	**0.030*****
	[0.08]	**[2.27]**	**[0.00]**	**[4.58]**
LNSIZE	-0.010***	-0.007***	0.029***	-0.007***
	[-4.29]	[-2.74]	[3.64]	[-4.09]
BM	-0.018**	-0.009	0.010	-0.021***
	[-2.40]	[-1.05]	[1.10]	[-6.97]
LEV	0.001	0.001	0.001	0.001
	[0.87]	[0.77]	[1.34]	[1.50]
LNOC	-0.002	-0.008	-0.001	0.003
	[-0.25]	[-1.07]	[-0.10]	[1.04]
Obs.	4,586	4,586	4,737	24,909
Adj. R^2	0.181	0.177	0.184	0.144

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In all regressions presented in this table, the dependent variable is the absolute value of discretionary accruals. To estimate discretionary accruals, we use the modified Jones model introduced by Dechow et al. (1995). All regression models are estimated with industry-, year- and state-fixed effects and standard errors are clustered by firm. In regressions (1) and (2), we compare firms with active political strategies (POL_ACT = 1) to all firms that did not have political action committees or engage in lobbying (POL_ACT = 0). To make sure that our inferences are not driven by the group of firms that did not engage in political actions having much more observations than the group of firms engaging in political actions and to correct for a possible selection bias, we use propensity score matching in regressions (1) and (2). It is conducted on a one-to-one basis by estimating the effect of LNSIZE, BM and INDPOLACT (the proportion of firms, in the same industry and fiscal year, which are politically active) on POL_ACT in a probit regression (similar to Bradley et al., 2015). To correct for a possible selection bias in a different way, we report the results of the second stage of the estimation of the Heckman (1979) model in columns (3) and (4). In the first stage, we use LNSIZE, BM and INDPOLACT again as variables for our selection equation to explain POL_ACT. In presenting these results, the coefficient on the inverse Mills Ratios is omitted. The regression F-test (untabulated) is significant at the 1% level in all the models.

POL_ACT is our proxy for active corporate political strategies. It is a coded as a dichotomous variable that takes the value of 1 if a firm has a political action committee, engages in lobbying, or does both, and 0 otherwise. To determine if a company actively carries out political strategies, we only considered those firm-years where we had both data on political action committees and lobbying.

PAI is our measure of proximity to political power. LNSIZE is the natural logarithm of the market value of equity. BM is the book value of equity over the market value of equity. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. MOMENTUM is the change in end of year stock prices from one year to the next one. More detailed variable descriptions are listed in Appendix A.

Table 7

Association between proximity to political power and earnings management with additional control variables and for profit and loss firms

	(1) Profit	(2) Loss	(3) all	(4) Profit	(5) Loss
PAI	**0.009*** **	**0.018*** **	**0.015*** **	**0.012*** **	**0.017** **
	[3.50]	**[2.80]**	**[3.87]**	**[2.87]**	**[2.24]**
LNSIZE	-0.010***	-0.011***	-0.007***	-0.005***	-0.007***
	[-27.92]	[-12.72]	[-14.68]	[-10.80]	[-6.36]
BM	-0.030***	-0.032***	-0.011***	-0.009***	-0.010***
	[-27.54]	[-19.74]	[-6.93]	[-4.27]	[-5.01]
LEV	0.001***	0.000	0.001***	0.000	0.000
	[3.42]	[-0.71]	[2.60]	[-0.01]	[1.19]
LNOC	0.013***	0.013***	0.005***	-0.005**	0.004
	[8.53]	[5.11]	[2.83]	[-2.30]	[1.17]
σ(CFO)			0.085***	0.175***	0.058***
			[12.20]	[13.83]	[7.07]
σ(SALES)			0.027***	0.010**	0.024***
			[9.90]	[2.57]	[5.97]
NEG_EARN			-0.003***	0.005***	-0.001
			[-3.30]	[3.89]	[-0.72]
CAP_INT			0.015***	0.037***	0.002
			[2.71]	[6.07]	[0.19]
INT_INT			-0.730***	-0.097	-0.430***
			[-11.96]	[-0.38]	[-6.65]
ZERO_INT			0.006***	0.005**	0.008**
			[3.19]	[2.34]	[2.07]
ALTZ			-0.001***	-0.002***	-0.002***
			[-5.43]	[-4.82]	[-5.02]
TAXEXP			0.149***	0.261***	0.016
			[5.39]	[6.78]	[0.26]
TQ			0.011***	0.017***	0.010***
			[9.98]	[10.84]	[6.40]
CFO			-0.135***	-0.280***	-0.108***
			[-17.31]	[-21.96]	[-10.31]
BIG5			-0.004**	-0.005**	-0.002
			[-2.53]	[-2.54]	[-0.59]
ATI			0.001	0.000	0.001
			[1.21]	[0.22]	[0.33]
Obs.	91,246	28,877	53,474	36,918	16,556
Adj. R^2	0.142	0.103	0.198	0.241	0.152

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In all regressions presented in this table, the dependent variable is the absolute value of discretionary accruals. To estimate discretionary accruals, we use the modified Jones model introduced by Dechow et al. (1995). All regression models are estimated with industry-, year- and state-fixed effects and with standard errors that are clustered by firm. The regression F-test (untabulated) is significant at the 1% level in all the models.

In regressions (1), (2), (4) and (5) we estimate the regression model separately for profit and loss firms. A firm is considered a profit (loss) firm if net income before extraordinary items (Compustat IB) is non-negative (negative).

PAI is our measure of proximity to political power. LNSIZE is the natural logarithm of the market value of equity. BM is the book value of equity over the market value of equity. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. See Appendix A for more detail on the definition of these variables.

σ(CFO) is the standard deviation of cash flow from operations (obtained as net income before extraordinary items, Compustat IB, minus total accruals, as defined in section 3), scaled by prior year total assets (Compustat AT), from year $(t-3)$ to year t. σ(SALES) is the standard deviation of sales (Compustat SALE), scaled by prior year total assets (Compustat AT), from year $(t-3)$ to year t. NEG_EARN is the frequency of negative earnings, measured as net income before extraordinary items (Compustat IB), from year $(t-3)$ to year t. CAP_INT is capital intensity, measured as the ratio of net property, plant and equipment (Compustat PPENT) divided by total assets (Compustat AT). INT_INT is intangible intensity, measured as the sum of reported R&D expense (Compustat XRD) and advertising expense (Compustat XAD) divided by sales (Compustat SALE), with R&D and advertising expenses being set to zero if absent. ZERO_INT a dummy variable for absence of intangibles. ALTZ is the Altman's Z score and it is defined in Section 5. TAXEXP is the total tax expense (Compustat TXT), scaled by prior year total assets (Compustat AT). TQ is Tobin's Q, defined in Section 5. CFO is cash flow from operations. BIG5 is a dummy variable for financial statements audited by Big 5 audit firms, calculated using data on the audit firm (Compustat AU). ATI is the antitakeover index developed by Bebchuk and Cohen (2003).

Table 8

Association between proximity to political power and earnings management aimed at smoothing

	(1) SMR	(2) SMQ
PAI	**2.148*** **	**0.200**
	[3.77]	**[1.42]**
LNSIZE	1.083***	0.435***
	[15.41]	[17.21]
BM	1.670***	0.463***
	[7.47]	[7.32]
LEV	0.122***	0.054***
	[2.86]	[4.09]
LNOC	-1.154***	0.184**
	[-4.93]	[2.20]
Obs.	54,188	78,846
Adj. R^2	0.099	0.063

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In the above regressions (1) and (2), the dependent variables are two smoothing ratios – SMR and SMQ – respectively. They are used instead of the absolute value of discretionary accruals as dependent variables to test the association of proximity to political power and earnings management aimed at smoothing. Both regressions are estimated with industry-, year- and state-fixed effects and with standard errors that are clustered by firm. The regression F-test (untabulated) is significant at the 1% level in all the models.

We calculate earnings management aimed at smoothing using two different ratios – SMR and SMQ. SMR is the standard deviation of a firm's quarterly income before abnormal accruals and extraordinary items (estimated separately for each industry quarter) over the standard deviation of its quarterly income before extraordinary items. SMR is based on the smoothing metric used in Pincus & Rajgopal (2002). SMQ is the standard deviation of a firm's quarterly cash flows of operations over the standard deviation of its quarterly income before extraordinary items.

PAI is our measure of proximity to political power. LNSIZE is the natural logarithm of the market value of equity. BM is the book value of equity over the market value of equity. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. See Appendix A for more detail on the definition of these variables.

Table 9

Mediating effect of committee chairmanships in the House or the Senate on the association between earnings management and proximity to political power

	(1) CHAIRMEN = 1	(2) CHAIRMEN = 0	(3) all
PAI	**0.032*** **	**0.007*** **	**0.008*** **
	[3.71]	**[2.59]**	**[2.99]**
CHAIRMEN			-0.007
			[-0.51]
PAIxCHAIRMEN			**0.023*** **
			[3.46]
LNSIZE	-0.013***	-0.012***	-0.012***
	[-13.63]	[-32.99]	[-33.12]
BM	-0.035***	-0.031***	-0.031***
	[-14.09]	[-29.74]	[-30.01]
LEV	0.001	0.001*	0.000*
	[1.51]	[1.83]	[1.77]
LNOC	0.013***	0.014***	0.013***
	[3.54]	[9.53]	[9.70]
LNSIZExCHAIRMEN			-0.002**
			[-2.14]
BMxCHAIRMEN			-0.004*
			[-1.79]
LEVxCHAIRMEN			0.001
			[1.03]
LNOCxCHAIRMEN			0.001
			[0.29]
Obs.	15,743	104,380	120,123
Adj. R^2	0.133	0.144	0.142

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In all regressions presented in this table, the dependent variable is the absolute value of discretionary accruals. To estimate discretionary accruals, we use the modified Jones model introduced by Dechow et al. (1995). All regression models are estimated with industry-, year-, and state-fixed effects and with standard errors that are clustered by firm. The regression F-test (untabulated) is significant at the 1% level in all the models.

CHAIRMEN indicates whether a firm has been exposed to a relevant change in chairmanship on any of the House or Senate committees. We deem a change relevant, if a House member or a senator of any firm's affiliated state gains or loses power on any of the House or Senate committee within the last reporting period. CHAIRMEN is a dichotomous variable that becomes 1 if a firm is subject to such a relevant change, while it is coded 0 otherwise. It is measured on the state-year level.

In regression (1), we estimate our model for the subsample of firm-years where firms have been subject to relevant changes in chairmanship on any of the House or Senate committees (CHAIRMEN = 1). In regression (2), we present results on the same regression model estimated for firm-years with no such changes (CHAIRMEN = 0). In regression (3), we include CHAIRMEN and respective interaction terms into the regression model.

PAI is our measure of proximity to political power. LNSIZE is the natural logarithm of the market value of equity. BM is the book value of equity over the market value of equity. LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. More detailed variable descriptions are listed in Appendix A.

Table 10

Time effects that influence the association between proximity to political power and earnings management

Reg.	Relevant time periods	coeff. on PAI		Obs.	Adj. R^2	coeff. on (PAI x TIME_DUMMY)
(1)	Election years (President, Congress, State)	0.014***	[3.92]	62,854	0.145	0.005
(2)	Non-election years (President, Congress, State)	0.009**	[2.49]	57,269	0.143	[1.14]
(3)	Election years (President)	0.018***	[3.60]	30,788	0.154	0.010*
(4)	Non-election years (President)	0.008***	[2.72]	89,335	0.142	[1.79]
(5)	Post-midterm	0.016***	[4.71]	61,346	0.14	0.012**
(6)	Pre-midterm	0.005	[1.21]	58,777	0.15	[2.45]
(7)	2 years to 1 year before presidential elections	0.014***	[3.31]	30,558	0.131	0.004 [0.84]
(8)	1 year to 0 years before presidential elections	0.018***	[3.60]	30,788	0.154	0.010* [1.79]
(9)	0 years to 1 years after presidential elections	0.003	[0.63]	29,314	0.161	-0.012** [-2.14]
(10)	1 years to 2 years after presidential elections	0.007	[1.31]	29,463	0.152	-0.004 [-0.79]
(11)	within 100 days before presidential election	0.027**	[2.08]	5,093	0.164	0.017 [1.29]
(12)	within 100 days after presidential elections	0.006	[0.87]	17,520	0.19	-0.008 [-1.13]

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In all regressions and for all regression coefficients presented in this table, the dependent variable is the absolute value of discretionary accruals. To estimate discretionary accruals, we use the modified Jones model introduced by Dechow et al. (1995). In the third column, we present the coefficient on PAI of our main regression model ($ABSDA = \beta_0 + \beta_1 PAI + CONTROLS + FIXED\ EFFECTS + \varepsilon$) estimated for the subsamples indicated in the second column; in the fourth and fifth columns we present the corresponding number of observations and the adjusted R^2. The subsamples are determined using dummy variables (TIME_DUMMY) that classify firms' fiscal years (based on the end of the fiscal year) into specific time periods within the electoral cycle. To test the statistical significance of these coefficient differences, we use an interaction regression ($ABSDA = \beta_0 + \beta_1 PAI + \beta_2 TIME\_DUMMY + \beta_3 PAI \times TIME\_DUMMY + (INTERACTED)\ CONTROLS + (INTERACTED)\ FIXED\ EFFECTS + \varepsilon$), which is run by using all the 120,123 in our main

sample, and report β_3 in the last column. In the interaction regressions presented in the first, second and third row, we use the TIME_DUMMY corresponding to Election years (President, Congress, State), Election years (President) and Post-midterm, respectively. In the interaction regressions reported in the remaining rows, we use the TIME_DUMMY corresponding to the period indicated in the second column. All regression models are estimated with industry-, year- and state-fixed effects and with standard errors that are clustered by firm. The regression F-test (untabulated) is significant at the 1% level in all the models.

Table 11

Results on proximity to political power and volatility of future operating profitability

	(1) σ(CFOF2)	(2) σ(CFOF3)	(3) σ(CFOF4)	(4) σ(CFOF5)
PAI	**0.004*** **	**0.004*** **	**0.005*** **	**0.004*** **
	[2.85]	**[2.76]**	**[3.23]**	**[2.80]**
LNSIZE	-0.010***	-0.011***	-0.011***	-0.011***
	[-39.11]	[-37.79]	[-36.06]	[-34.25]
BM	-0.021***	-0.021***	-0.020***	-0.019***
	[-25.23]	[-23.46]	[-21.16]	[-19.22]
LEV	-0.001***	-0.001***	-0.001***	-0.001***
	[-4.69]	[-6.29]	[-6.05]	[-5.73]
LNOC	0.002*	0.002**	0.003***	0.003***
	[1.67]	[2.30]	[2.95]	[3.15]
CFO	-0.106***	-0.125***	-0.132***	-0.136***
	[-27.11]	[-29.95]	[-30.09]	[-28.65]
DA	-0.061***	-0.078***	-0.088***	-0.095***
	[-11.38]	[-14.35]	[-16.25]	[-16.65]
NDA	-0.036***	-0.049***	-0.055***	-0.060***
	[-6.17]	[-8.47]	[-9.16]	[-9.59]
Constant	0.104***	0.105***	0.103***	0.105***
	[8.77]	[9.21]	[9.37]	[9.21]
Obs.	96,943	87,412	78,939	71,344
Adj. R^2	0.152	0.225	0.265	0.292

Robust t-statistics in brackets

*** p<0.01, ** p<0.05, * p<0.1

In all regressions presented in this table, a variable the captures future operating profitability is used. σ(CFOF2), e.g., stands for the standard deviation of future operating profitability, with the future two years of operating cash flows (CFOs) being used in the standard deviation calculation. Note that CFO is used as our proxy for operating profitability in these analyses. It is calculated as income before extraordinary items (Compustat IB) minus total accruals, as defined in Section 3.

PAI is our measure of proximity to political power. BM is the book value of equity over the market value of equity. DA stands for discretionary accruals which we estimated using the modified Jones model introduced by Dechow, Sloan and Sweeney (1995). LEV is total liabilities over equity. LNOC is the natural logarithm of the operating cycle. LNSIZE is the natural logarithm of the market value of equity. NDA stands for non-discretionary accruals. More detailed variable descriptions are listed in Appendix A.

All regression models are estimated with industry-, year- and state-fixed effects and with standard errors that are clustered by firm. The regression F-test (untabulated) is significant at the 1% level in all the models.